

BEFORE THE STATE BOARD OF EQUALIZATION
OF THE STATE OF CALIFORNIA

In the Matter of the Appeal of)
DPF INCORPORATED)

For Appellant: Laurence Peters
Attorney at Law

For Respondent: James C. Stewart
Counsel

O P I N I O N

This appeal was originally made pursuant to section 25666 of the Revenue and Taxation Code from the action of the Franchise Tax Board on the protest of DPF Incorporated against proposed assessments of additional franchise tax in the amounts of \$1,321.49, \$41,890.40 and \$43,889.09 for the income years ended May 31, 1973, May 31, 1974, and May 31, 1975, respectively. Subsequent to the filing of this appeal, appellant paid the proposed additional tax with interest, so this appeal is now treated as an appeal from the denial of claims for refund pursuant to section 26078 of the Revenue and Taxation Code.

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The sole issue for determination is whether the gain realized by appellant due to its repurchase of its debentures is business income apportionable by formula or nonbusiness income specifically allocable to appellant's commercial domicile outside California.

Appellant is a Delaware corporation maintaining its principal offices in New York. During the appeal years, appellant's commercial domicile was located outside the State of California, presumably in New York. Appellant's business during these years consisted principally of leasing computers which it purchased from IBM.

Appellant made public offerings of 20-year convertible debentures in March and September of 1967, resulting in the issuance of debentures with an aggregate face amount of \$62,000,000. The funds thus made available were used to purchase additional computer inventory for appellant's leasing business. Interest paid to the debenture holders of 5-3/4 and 5-1/2 percent per annum for the March and September issues, respectively, was treated by appellant for franchise tax purposes as a deductible expense of its unitary leasing business.

Interest rates rose substantially during the appeal years, depressing the market value of the debentures, which had low, fixed interest rates. At the same time, however, appellant's cash flow increased considerably, allowing it to repurchase some of its debentures in the open market at the depressed prices. The reacquisition of these debentures resulted in substantial realized gains, which appellant reported in its returns as nonbusiness income specifically allocable to its commercial domicile. On audit, however, respondent determined that such gains constituted business income subject to formula apportionment. Whether that determination was correct is the only issue we must resolve.

"Business income" and "nonbusiness income" are defined in section 25120 of the Revenue and Taxation Code as follows:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property

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constitute integral parts of the taxpayer's regular trade or business operations.

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(d) "Nonbusiness income" means all income other than business income.

It is now well settled that the above definition of business income provides two alternative tests for determining the character of income. The "transaction test" looks to whether the transaction or activity which gave rise to the income occurred in the regular course of the taxpayer's trade or business. Alternatively, the "functional test" provides that income is business income if the acquisition, management, and disposition of property giving rise to the income were integral parts of the taxpayer's regular business operations, regardless of whether the income was derived from an occasional or extraordinary transaction. (Appeal of Fairchild Industries, Inc., Cal. St. Bd. of Equal., Aug. 1, 1980; Appeal of New York Football Giants, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977; Appeal of Borden, Inc., Cal. St. Bd. of Equal., Feb. 3, 1977.) of

Appellant takes the position that neither of the alternative tests is satisfied: therefore, the gains realized from the repurchase of its debentures were non-business income. Although appellant concedes that it issued the debentures in the regular course of its business, it argues that the reacquisition of those debentures was not part of its regular business operations, but was merely the investment of idle funds. Appellant concludes that the transaction test is therefore unsatisfied. It argues further that the assets giving rise to the gains were "idle funds," not necessary for its business, rather than assets which were used as an integral part of its business. As a result, appellant contends, the functional test is also not met. We find, however, that the gains were business income within the meaning of the functional test. Consequently, it is not necessary for us to decide whether, they would be business income under the transaction test.

Appellant's argument appears to be based primarily on its characterization of the gains as "investment income," the source of which it contends was "idle funds." However, as the regulations accompanying section 25120 make clear, classifying income by

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a particular label **does not** aid in determining whether it is business or nonbusiness income. (Cal. Admin. Code, tit. 18, reg. 25120, subd. (c) (art. 2); Cal. Admin. Code, tit. 18, reg. 25120, subd. (a) (art. 2.5).) In order to ascertain the correct treatment of income, we must look beyond labels to the practical realities of the situation.

The gains here resulted from appellant's repurchases of some of its own outstanding debentures. Although appellant undoubtedly examined these transactions at least partly on their merits as investments, they were in reality not merely passive investments,, but were active reductions of outstanding corporate liabilities for interest and principal payments. As appellant states in its brief, in these transactions

the advantages incidental to a stock repurchase were also present, since the possibility of an increase in the outstanding common stock of the Taxpayer through conversion of the debentures was eliminated to the extent debentures were repurchased.

These additional factors take these transactions outside the **realm** of the typical "passive investment," unrelated to appellant's regular business, and into the area of active planning and manipulation of appellant's capital structure. In this context, we think the acquisition, management and disposition of its own securities by a taxpayer engaged in a single trade or business constitute integral parts of that trade or business, giving rise to business income. This is true even though the transactions involving its own securities might be occasional or extraordinary events (Appeal of Borden, Inc., supra), and it is the only conclusion consistent with appellant's treatment of the interest paid to debenture holders as a deductible expense of its unitary leasing business.

Appellant cites the decisions in American President Lines, Ltd. v. Franchise Tax Board, 3 Cal.App. 3d 587 (83 Cal.Rptr. 702) (1970), Fibreboard Paper Products Corp. v. Franchise Tax Board, 268 Cal.App.2d 363 [74 Cal.Rptr. 46] (1968), Appeal of American Airlines, Inc., Cal. St. Bd. of Equal., Dec. 18, 1952, and Appeal of Crown Zellerbach Corp., Cal. St. Bd. of Equal., Feb. 17, 1959, in support of its position.

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In both Fibreboard and American President Lines, the taxpayers had their commercial domiciles in Cornia. As we stated in Appeal of General Dynamics Corp., decided by this board on June 3, 1975, the issue in both these cases

was whether the income from intangibles should be specifically allocated by **situs** pursuant to section 23040 of the Revenue and Taxation Code, which could not occur in the absence of local domicile, not whether California could reach the income by the apportionment formula or not at all. In the latter case section 23040 would not apply.

Here, as in General Dynamics/, supra, the question is whether California can reach the income by the apportionment formula or not at all. In both Appeal of American Airlines, Inc., supra, and Appeal of Crown Zellerbach Corp., supra, interest from investments in United States securities was held to be not so integral to the unitary businesses involved as to be **apportionable** by formula. Such a finding is not justified by the facts in the instant case.

We also note that all four of the matters cited by appellant arose before the effective date of the Uniform Division of Income for Tax Purposes Act (Rev. & Tax. Code, §§ 25120-25139), and under that act and its regulations, the above cited matters would be decided differently.

For the reasons stated herein, we sustain respondent's action.

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ORDER

Pursuant to **the views** expressed in the opinion of the board on file in this proceeding, and good cause appearing therefor,

IT IS HEREBY ORDERED, ADJUDGED AND DECREED, pursuant to section 26077 of the Revenue and Taxation Code, that the action of the Franchise Tax Board in denying the claims of DPF Incorporated for refund of franchise tax in the amounts of **\$1,321.49, \$41,890.40** and **\$43,889.09** for the income years ended May 31, 1973, May 31, 1974, and May 31, 1975, respectively, be and the same is hereby sustained.

Done at Sacramento, California, this 28th day
of October, 1980, by the State Board of Equalization,
with Members Nevins, Reilly, Dronenburg and Bennett present.

Richard Nevins, Chairman
George R. Reilly, Member
Ernest J. Dronenburg, Jr., Member
William M. Bennett, Member
_____, Member